1.06 Financial Statement Disclosures

Notes to Financial Statements

The notes to the F/S are used to ensure that all disclosures that are required under GAAP are made (ASC 235).

- Summary of significant accounting policies – This is usually either the first or second footnote and describes the selection of significant accounting principles and methods used in the F/S (eg, inventory costing method). Specific items it will include are:
  - The basis for consolidation
  - Depreciation methods
  - Amortization of intangibles
  - Recognition of revenue from contracts with customers
  - Recognition of revenue from leasing contracts
- Summary of significant assumptions – For **prospective** F/S (those that present forecasted or projected future results), this describes the assumptions used to estimate future amounts (eg, anticipated rate of inflation).
- Other notes to the financial statements – The other footnotes contain all the other relevant information that investors and creditors may find useful, such as information regarding:
  - Contingent liabilities
  - Contractual obligations
  - Amount coming due for bonds and leases in the next 5 years and the aggregate beyond 5 years
  - Significant changes in account balances

Inflation Accounting

Accounting for the **effects of changing prices** is **optional** (ASC 255). When the client elects to present such data as supplementary information accompanying the basic financial statements, it may present two different types of information:

- Current cost information
- Price-level adjusted data

To understand the effects of changing prices, it is important to distinguish monetary assets and liabilities from nonmonetary items.

- A **monetary** item is an asset or liability whose value is *fixed in money terms*. Examples include:
  - Cash
  - Accounts and notes receivable
  - Bond investments that will be held to maturity

- Prepaid expenses
- Accounts, notes, and bonds payable

- A **nonmonetary** item is one that does not guarantee a fixed amount of money being received or paid. Examples include:
  - Inventories
  - Plant and equipment
  - Intangibles
  - Marketable securities (including bonds that may be sold prior to maturity)

Current cost accounting reports assets on the balance sheet at replacement cost. In determining the replacement cost of fixed assets, the estimated cost of a used asset must be utilized. If this isn't available, the cost of a new asset may be adjusted for estimated depreciation.

Assume the client acquired a machine with a 10-year life and no expected salvage value on 1/1/X1 for $100, and that it was being depreciated on a straight-line basis. At 12/31/X3, accumulated depreciation was $30 and book value was $70.

In determining the current cost of the machine, the client is unable to identify a price for a 3-year-old machine, but the replacement cost for an identical new machine on 12/31/X3 was $120.

By applying the same depreciation approach, accumulated depreciation is estimated at $120 × 3 / 10 = $36, and the current cost of the machine is reported at $120 – $36 = $84.

On the income statement, cost of sales is reported at the average current cost of goods sold.

Assume the following historical information is available for FIFO calculation of cost of sales in 20X1:

	Units	Dollars
Beginning inventory	10	100
Purchases	40	440
Ending inventory	(20)	(280)
Cost of sales	30	260

The current cost of the inventory was $10 per unit at 1/1/X1 and $14 per unit at 12/31/X1, so the average current cost per unit was $12. The average current cost of goods sold was 30 units × $12 per unit = $360.

Price-level adjusted numbers continue to carry assets at historical cost, but nonmonetary items are adjusted to reflect changes in the consumer price index.

For example, if land was acquired in 20X1 at $500 when the price index was 1.00, and the price index at 12/31/X3 is 1.10, the land is carried on a price-level adjusted 12/31/X3 balance sheet at $500 × 1.10 / 1.00 = $550.

Monetary assets and liabilities are not adjusted for inflation, since they do not increase in value from it. The failure of these items to increase results in a purchasing power loss when monetary assets are held and a purchasing power gain when monetary liabilities are held (since the failure of assets to rise in value is unfavorable but the failure of liabilities to increase is favorable).

To measure purchasing power gains and losses, a calculation is made of the change in value that would have occurred on net monetary items if they had been nonmonetary, and this is compared to their actual value. Since the calculation is being made of the gain or loss over the course of the year, all amounts are adjusted to reflect the average price level for the year.

If inflation:	
Monetary ASSET	Purchasing power LOSS
Monetary LIABILITY	Purchasing power GAIN

Assume a client began the year with net monetary assets of $400 and ended the year with net monetary assets of $600. The price index at the beginning of the year was 1.00 and at the end of the year 1.20, with an average of 1.10. Expressed in nominal dollars, the change during the year can be summarized as:

Beginning	$400
Increase	200
Ending	$600

If all of the figures are adjusted to a common price level of 1.10 (the average for the year), then beginning net monetary assets are $400 × 1.10 / 1.00 = $440, the increase (which occurred over the course of the year) is $200 × 1.10 / 1.10 = $200, and the ending net monetary assets are $600 × 1.10 / 1.20 = $550. The amounts do not reconcile, though, and the discrepancy is the purchasing power loss:

Beginning	$440
Increase	200
Subtotal	$640
Ending	550
Discrepancy	$90

The discrepancy is a purchasing power loss to the company, because it represents the difference between what the assets would have been worth if they had benefited from inflation ($640) and what they were actually worth ($550).

Risks & Uncertainties

ASC 275 requires disclosure in the F/S of risks and uncertainties existing as of the date of those statements. The **four areas of disclosure** are:

- Nature of operations

- Use of estimates
- Certain significant estimates
- Current vulnerability associated with certain concentrations

Disclosure of the **nature of operations** will include a description of how the entity generates revenue, such as major products and services and principal markets served.

- Entities providing multiple products and services will include an indication of their relative importance.
- Not-for-profit entities will include a description of the principal services provided and the entity's revenue sources.

Disclosures related to the **use of estimates** should indicate that the preparation of F/S in accordance with GAAP, as well as other applicable financial reporting frameworks, require the use of estimates. Users are also cautioned that actual results may differ from those estimates.

Certain significant estimates include those for which it is at least reasonably possible that a material change in the estimate will occur in the near term. For these items, the entity will disclose the nature of the uncertainty and that a change in the estimate is at least reasonably possible. When the estimate relates to a contingent liability, disclosure will include:

- An estimate of a possible loss (the possible range of loss when a specific amount cannot be reasonably estimated), or
- The fact that an estimate cannot be made, if appropriate.

Current vulnerability due to certain concentrations occur when an entity does not diversify. This may result from doing large amounts of business with a limited number of customers; relying on a limited number of products or services; providing goods or services to customers in limited geographical areas or with limited demographics; or relying on few suppliers for materials, labor, or services. An entity will disclose information about such concentrations that exist at the balance sheet date if:

- The entity is vulnerable to a possible severe impact in the near term; and
- Events that would cause the severe impact are at least reasonably possible in the near term.